EXEMPTION OF STATE AND MUNICIPAL SECURITIES FROM FEDERAL INCOME TAXATION.

UNDER the Revenue Law of 1918,[1] interest derived from securities issued by a State or any political subdivision thereof is declared exempt from federal tax.

The original bill contained a provision taxing the interest from future issues of State and municipal securities, but it was stricken out in the Senate because of its doubtful constitutionality. In the three years during which the present law has operated, there has been a fairly adequate opportunity for observing the effects of this exemption. This is an opportune time, in view of the impending revision of the federal tax system, to consider the desirability and the legal practicability of abandoning this exemption policy.

Considered in its economic aspects, the practical effect of exempting the interest from State and municipal securities has been so serious as to threaten the eventual breakdown of the whole tax structure. The financial exigencies of the federal government are such as to demand the retention of a progressive income tax system like that embodied in the present law. The progressive principle cannot, however, exist for any considerable period side by side with broad exemptions which tend to defeat its effective operation. The experience of the past three years demonstrates this very clearly. Under the federal income tax law an attempt is made to distribute the tax burden roughly in accordance with ability to pay. Certain kinds of exemptions are granted therein for purely fiscal or administrative reasons. The exemption of interest derived from State and municipal bonds, as well as the salaries of State and municipal employees, was based on legal grounds. The preferential treatment has no relation to the principles governing the equitable apportionment of the tax burden.

[1] Act approved Feb. 24, 1919 (40 Stat. L. 1088) sec. 213.

It has been estimated [2] that the aggregate par value of State and municipal securities now outstanding is at least four billions of dollars. This represents an annual withdrawal of about one hundred and sixty millions from taxation and a loss in revenue to the government of some thirty-five millions. A taxpayer whose net income would be taxable at fifty per cent would require a taxable bond yielding ten per cent to make it as attractive as a five per cent municipal bond.[3] Tax rates are virtually made to depend upon the *character* of a taxpayer's income, rather than upon its *amount.*

As a result, we find that the upper brackets of the surtaxes have become non-productive. The loss in revenue has assumed such proportions as to make a revision of the law quite essential. If a given yield from the sources now tapped by the income tax is to be maintained, it must be raised either by an increase in the rate of the tax or by a better distribution of the tax burden than under the present law. Obviously, the latter course has a greater chance of practical accomplishment.

If the progressive income tax is retained, is it constitutionally permissible to tax the income derived from State municipal securities? On this question there is a difference of legal opinion. Hence a review of the authorities is warranted.

Taxable Status before Sixteenth Amendment.

In order to understand the reason why, in the absence of an express limitation on the federal taxing power, State and municipal securities have enjoyed exemption, it is necessary to consider the decisions antedating the Sixteenth Amendment. The origin of this doctrine may be traced back to M'Culloch *v.* Maryland,[4] decided in 1819. Chief Justice Marshall there announced the principle that a State may not tax the operations of a local branch of a United States Bank. As the bank was

[2] Prof. G. E. Putnam, "Investment Securities and Tax Exemption", VII Washington Univ. Studies, p. 24.

[3] The capitalized value of the loss in revenue to the United States on this volume of bonds maturing in 20 years is $479,455,000. (Prof. G. E. Putnam, *ibid.*, p. 24.)

[4] 4 Wheat. 316; see Osborn *v.* Bank, 9 Wheat. 738 (1824).

an agency of the federal government, the tax upon its operations amounted to a tax upon the insruments employed to carry out governmental powers, and was beyond the State's power.

In Weston *v.* City of Charleston,[5] decided a decade later, the Supreme Court held that a tax upon federal bonds under State authority could not be levied consistently with the Constitution. The right to tax the contract was said to affect the power to borrow money; to any extent, however inconsiderable, it is a burden on the operations of the government.[6]

In Pollock *v.* Farmers' Loan & Trust Co.,[7] the Supreme Court agreed unanimously that the same reasons which precluded the federal government from taxing the property or revenues of States and municipalities likewise prevented a tax on the income from their securities. The reasons set forth in Weston *v.* Charleston were declared equally applicable in the converse case.

From this brief review of the early cases it appears that, in the absence of a specific provision of the Constitution exempting State and municipal securities from federal taxation, the Supreme Court found an implied limitation on the taxing power of Congress. This was said to arise by necessary implication out of the duality of our form of government, and the necessity for its self-preservation. The court has heeded Marshall's *dictum* that "the power to tax is the power to destroy". Hence, the agencies of the federal government were not to be burdened by State taxation. Conversely, the function of issuing bonds under State authority was, by a reciprocal limitation, held to be immune from tax both upon the income and the source thereof.

Effect of the Sixteenth Amendment.

This was the condition of the law at the time of the passage of the Sixteenth Amendment, which provides as follows:

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[5] 2 Pet. 449 (1829).

[6] As to the subsequent modification of this doctrine, see Bank of Commerce *v.* New York City, 2 Black 620 (1862) and Bank Tax Case, 2 Wall. 200 (1864). Also excellent discussion in T. R. Powell's articles, "Indirect Encroachment on Federal Authority by the Taxing Powers of the States", 31 Harv. L. Rev. 331-35, 902-31.

> "Congress shall have power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Whether or not State and municipal securities can be constitutionally subjected to federal income taxation hinges chiefly on the interpretation of the words "from whatever source derived", found in the Amendment. The controversy which has arisen over their interpretation is borne out of two different views of the Amendment's scope and purpose. One view is that its words should be interpreted in a natural and obvious sense. Accordingly, the Amendment is said to be a grant of power to levy income taxes on all sources, including those sources which were formerly excepted from taxation. From this point of view, it follows that Congress presently possesses the power to tax the income derived from State securities.[8]

The opposing view claims that the Amendment must be construed in the light of the history and circumstances which moved its adoption.[9] The Amendment grew out of the situation following the decision in the Pollock case. A majority of the Supreme Court there held that in so far as taxes upon the income from real estate and personal property were direct, they required apportionment. The purpose of the Amendment, it is claimed, was to eliminate the requirement of apportionment. The only effect of the words "from whatever source derived" was to remove all discrimination between sources that could already be taxed without apportionment and

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[7] 157 U. S. 429, 585 (1895). See Farmers Bank *v.* Minnesota, 232 U. S. 516 (1914). Collector *v.* Day, 11 Wall. 113 (1871), held that the salary of a State judge could not be subjected to federal tax. See also Dobbins *v.* Commissioners of Erie County, 16 Pet. 435; U. S. *v.* B. & O. R. Co., 17 Wall. 322.

[8] H. Hubbard, "The Sixteenth Amendment", 33 HARV. L. REV. 794 (April 1920). Special Message of Gov. Hughes, reprinted in FOSTER, INCOME TAX, 2d. ed., p. 78. C. E. Clark, "Some Income Tax Problems", 29 YALE LAW JOURN. 735, Note 26.

[9] Legal Tender Cases, 12 Wall. 457, 534 (1871); Maxwell *v.* Dow, 176 U. S. 581 (1900); Briscoe *v.* Bank of Ky., 11 Pet. 257 (1837); South Carolina *v.* United States, 199 U. S. 437 (1905).

sources that could previously be taxed only by means of an apportionment.

The change did not affect the power to tax, but only the method of exercising an existing power.[10] If the effect of the Amendment was to introduce a single exception to a general rule rather than to confer a power to tax new subjects, then the exemption of State and municipal securities was not disturbed.

Several cases decided since the Amendment became effective have interpreted the words "from whatever source derived". None of these cases directly involved the taxability of income from State securities; hence they are not conclusive on the question here considered. They contain, however, much light on the scope and operation of the Amendment.

In Brushaber *v.* Union Pacific R. Co.,[11] Chief Justice White, after a comprehensive review of the events which led to the adoption of the Amendment, declared that it "does not purport to confer power to levy income taxes in a generic sense." The conclusion was to his mind irresistible that the only purpose of the Amendment was to do away for the future with the principle upon which the Pollock case was decided, namely the apportionment of direct taxes.

In Peck *v.* Lowe,[12] a unanimous court reaffirmed this view, saying:

> ". . . . As pointed out in recent decisions, it does not extend the taxing power to new or excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from one source or another."

In the recently decided Stock Dividend case, Eisner *v.* Ma-

[10] A. C. Ritchie, "Power of Congress to Tax State Securities", REPORT AM. BAR ASS'N. 1920, p——, and 4 AM. BAR ASS'N. JOURNAL, p. 602 (Oct. 1919); letter of Senator Root, reprinted in FOSTER, INCOME TAX, 2d. ed., p. 80. Speech of Senator Borah, 10 JOURN. OF ACCTCY. 33; SELIGMAN, INCOME TAX, pp. 600-614.

[11] 240 U. S. 1 (1916). See the review of this decision in the writer's article, "Limitations upon the Federal Taxing Power", 3 NATL. TAX ASS'N. BULLETIN, pp. 34-39.

[12] 247 U. S. 165 (1918).

comber,[13] the court took occasion to consider at length the effect of the Sixteenth Amendment, and in reaching the same conclusion, substantially repeated the extract quoted from Peck *v.* Lowe, *supra.*

This brings us to the recent pronouncement of the Supreme Court in Evans *v.* Gore,[14] decided last June. In that case a federal income tax was levied on the salary of a United States District Judge, in office at the time of the adoption of the Revenue Act imposing the tax. The issue, as stated by the court, was this: "Does the Sixteenth Amendment authorize and support this tax and the attendant diminution; that is to say, does it bring within the taxing power subjects theretofore excepted?" After a review of the earlier cases, the court concluded that the Amendment did not authorize the tax in question. In the course of the majority opinion, significant mention is made of the fact that Governor Hughes in a message expressed some apprehension that the Amendment might be construed to embrace within the tax power income from State bonds. In regard to this, the Court said:

> ". . . his message promptly brought forth from statesmen who participated in proposing the Amendment such convincing expositions of its purpose, *as here stated,* that the apprehension was effectively dispelled and ratification followed."

Despite the fact that the decision in Evans *v.* Gore is of far-reaching importance, it has not evoked much comment. Mr. Justice Holmes filed a dissenting opinion, in which Mr. Justice Brandeis concurred. The minority view is especially significant for its non-technical construction of the words "from whatever source", found in the Sixteenth Amendment. Whereas the majority of the court hold that these words do not bring new subjects within the taxing power, the minority declare that the Amendment was enacted not merely to obviate a single difficulty but to end the necessity for tracing income to its source.

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[13] 40 Sup. Ct. 189 (March 1920).
[14] 40 Sup. Ct. 550 (June 1920).

Is State Derived Income Subject to Surtaxes?

The fate of directly taxing the income from State and municipal bonds appears to be sealed. An indirect approach toward the same end has been proposed by the Secretary of the Treasury.[15] His recommendation contemplates that such income should be reported and included in the individual taxpayer's total net income, and the taxable portion of his income taxed at the rates applicable to the total net income. The surtax rates would be applied by reference to the aggregate of taxable and exempt income. The tax, thus arrived at, would be diminished by the proportion which the income from tax free sources bears to the entire net income.

Is this proposed formula open to legal objection? In support of its validity, it may be pointed out that its purpose is essentially administrative, seeking to prevent tax evasion. In the latter respect, Congress ordinarily has wide discretion.[16] The method of assessment proposed does not involve unjust discrimination, but makes for substantial equality in apportioning taxes upon income.

In effect, the proposal would adopt, as a measure of a general and non-discriminatory income tax, income derived from sources in themselves exempt. It should be noted that, in the above formula, express provision is made for deducting a proportion of the tax computed. There is, consequently, proper recognition made of income from tax exempt sources. The tax allocated to interest from State and municipal bonds would, therefore, be proportionally deducted from the tax on the total net income.

There is judicial authority for adopting as a measure of a tax values which are not within the jurisdiction of the taxing

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[15] Report of the Secretary of the Treasury for fiscal year ended June 30, 1919, p. 24. The legislation would apply to future issues of State and municipal securities, and apparently to Farm Loan bonds. All of these could then have the same exemption as federal obligations.

[16] Bell's Gap R. Co. *v.* Pa., 134 U. S. 232 (1890); St. Louis Southern R. Co. *v.* Arkansas, 235 U. S. 350.

power.[17] Thus, in a comparatively recent case,[18] involving the New Jersey inheritance tax law, the Supreme Court upheld a tax which applied the following formula: The tax on the estate of a non-resident decedent is first determined as if the estate were that of a resident; the tax payable being such portion of this amount as the property within the State bears to the entire estate wherever located. This clearly recognizes that there is no constitutional prohibition against using property not in itself taxable as a measure of the tax imposed. A variant of the same idea is found in the imposition of a retroactive tax measured by income for a period which has elapsed at the time that a revenue law goes into operation.[19]

On the other hand, it may be urged that the proposal here discussed accomplishes by indirection what cannot be done directly. Mr. Justice Holmes has said:[20]

> "Many things that a Legislature may do if it does them with no ulterior purpose, it cannot do as a means to reach what is beyond its constitutional power. That I understand to be the principle of Western Union Telegraph Company *v.* Kansas, Pullman Co. *v.* Kansas, and other cases in 216 U. S.; Western Union Telegraph Co. *v.* Foster, 247 U. S. 105, 114."

The principle enunciated in Peck *v.* Lowe[21] and in United States Glue Co. *v.* Oak Creek[22] apparently extends to this situation. The former case held that a tax upon income derived from the exporting business does not violate the constitutional provision prohibiting taxes on exports. In the latter case, a similar holding was made as to a State tax on income derived from interstate commerce. These authorities were relied on

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[17] Peck *v.* Lowe, *supra;* U. S. Glue Co. *v.* Oak Creek, 247 U. S. 321. As applied to State franchise taxation, a similar formula has been approved. See T. R. Powell, *op. cit.*, p. 721 *et seq.*

[18] Maxwell *v.* Bugbee, 40 Sup. Ct. 2 (1919). See also Plummer *v.* Coler, 178 U. S. 115 (1900).

[19] Brushaber *v.* Union Pacific R. Co., *supra.* Edwards *v.* Keith, 224 Fed. 585 (1915).

[20] Maxwell *v.* Bugbee, *supra,* in dissenting opinion.

[21] *Supra,* note 12.

[22] *Supra,* note 17.

to support a similar argument in Evans *v.* Gore, *supra,* but the court there dismissed them as not pertinent.

Were this proposal to come before the Supreme Court, it would most likely be subjected to an economic test in order to determine its legal validity. The sole inquiry would be: Does the tax impair the borrowing power of the States? The burden upon the States' credit would be felt in the necessity for raising interest rates by the borrower in future issues sufficient to capitalize the tax. This would result from the removal of the subsidy which the States have so far enjoyed, and can hardly be regarded as controlling the operations of the State governments. Considering the serious economic effects to the federal tax system of the exemption of interest from State and municipal securities, the impairment of the States' borrowing power which would result from the elimination of this exemption would, by comparison, be deemed slight.

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